MARCH 2023

JohnsonLambert
cpas + consultants

Estimates, Specialists, and Risk Assessment

Upcoming Changes in Auditing Standards

Author:

Melanie Barthel

Johnson Lambert LLP is dedicated to keeping you informed on the impact of upcoming auditing standards. The American Institute of Certified Public Accountants (AICPA) has issued Statements on Auditing Standards (SAS) 143-145, which address estimates, the use of specialists, and the risk assessment process for audits of financial statements for periods ending on or after December 15, 2023.

Background and Overview

Following the release of several auditing standards effective in 2021 (SAS 134-141) which brought significant changes to the auditor's report, and the release of SAS 142 effective in 2022 related to audit evidence, the AICPA has released further updates applicable to audits of financial statements for periods ending on or after December 15, 2023 as follows:

- **SAS 143** *Auditing Accounting Estimates and Related Disclosures*
- **SAS 144** *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*
- **SAS 145** *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

The impetus for such changes comes from a variety of factors including:

+ Changes in accounting standards,
+ Recent changes in Public Company Accounting Oversight Board (PCAOB) and international auditing standards,
+ Observations from AICPA peer reviews, and
+ The need for modernization in the standards.

SAS 143: Accounting Estimates and Disclosures

What's Changing?

SAS 143 (Estimates) clarifies the auditor's responsibilities for evaluating accounting estimates, including fair value accounting estimates and related disclosures. The standard is designed to be scalable for all types of estimates, from the simple to the increasingly complex. The standard also provides guidance for determining whether the evaluation of accounting estimates requires specialized skills or knowledge, including the use of an auditor's specialist, as further discussed in SAS 144 (Specialists).

The standard requires the auditor to separately assess the inherent risk[1] and control risk[2] related to accounting estimates to determine the associated risk of material misstatement (ROMM). The auditor then develops procedures in response to the associated ROMM using one or more of the approaches in the diagram below.

Taking the evidence obtained from the approach(es) used into account, the auditor is able to conclude on whether estimates are reasonable in the context of the applicable financial reporting framework and whether sufficient appropriate evidence has been obtained in response to the associated ROMM.

The standard also provides considerations for when the engagement team requires specialized skills or knowledge to perform risk assessment procedures, identify and assess the risks of material misstatement, design and perform audit procedures in response to those risks, or evaluate the audit evidence obtained. Matters affecting this determination include the nature of the estimates for a business or industry (e.g. complex financial instruments, insurance contract liabilities, or retirement plan obligations), the degree of estimation uncertainty, and the complexity of the underlying methods, models, and applicable financial reporting framework.

1. Inherent Risk – susceptibility to a material misstatement before consideration of any related controls
2. Control Risk – risk that a material misstatement will not be prevented, or detected and corrected, by the entity's system of internal control

What to Expect

Risk Assessment and Fieldwork

Management can anticipate audit procedures and inquiries focused on obtaining an understanding of the entity, its environment, and its system of internal control in order to identify and assess the ROMM related to estimates and to understand the underlying data, methodology, and assumptions used in the estimation process. To the extent that management utilizes a specialist in the estimation process, the new procedures will require an increased collaboration between the auditor and the specialist. The scope of the auditor's procedures is also highly dependent on the volume and complexity of significant accounting estimates applicable to the entity.

Communications with Those Charged with Governance

The auditor has certain communication requirements with those charged with governance, including the auditor's views about the qualitative aspects of the entity's significant accounting policies and sensitive accounting estimates. SAS 143 provides that the auditor needs to consider certain matters regarding accounting estimates as part of this communication.

Additional matters specific to accounting estimates that the auditor may consider communicating with those charged with governance at the conclusion of the audit include:

+ Risks of material misstatement,
+ Relative materiality of the estimates to the financial statements as a whole,
+ Whether management has applied appropriate specialized skills or knowledge,
+ Auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial statements, and
+ Indicators of possible management bias.

Written Representations

At the conclusion of the audit, the auditor requests certain written representations from management. Under SAS 143, such representations will include whether the methods, significant assumptions, and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement, or disclosure that is in accordance with the applicable financial reporting framework. The auditor may also need to obtain additional representations about specific accounting estimates.

SAS 144: Use of Specialists and Pricing Information

What's Changing?

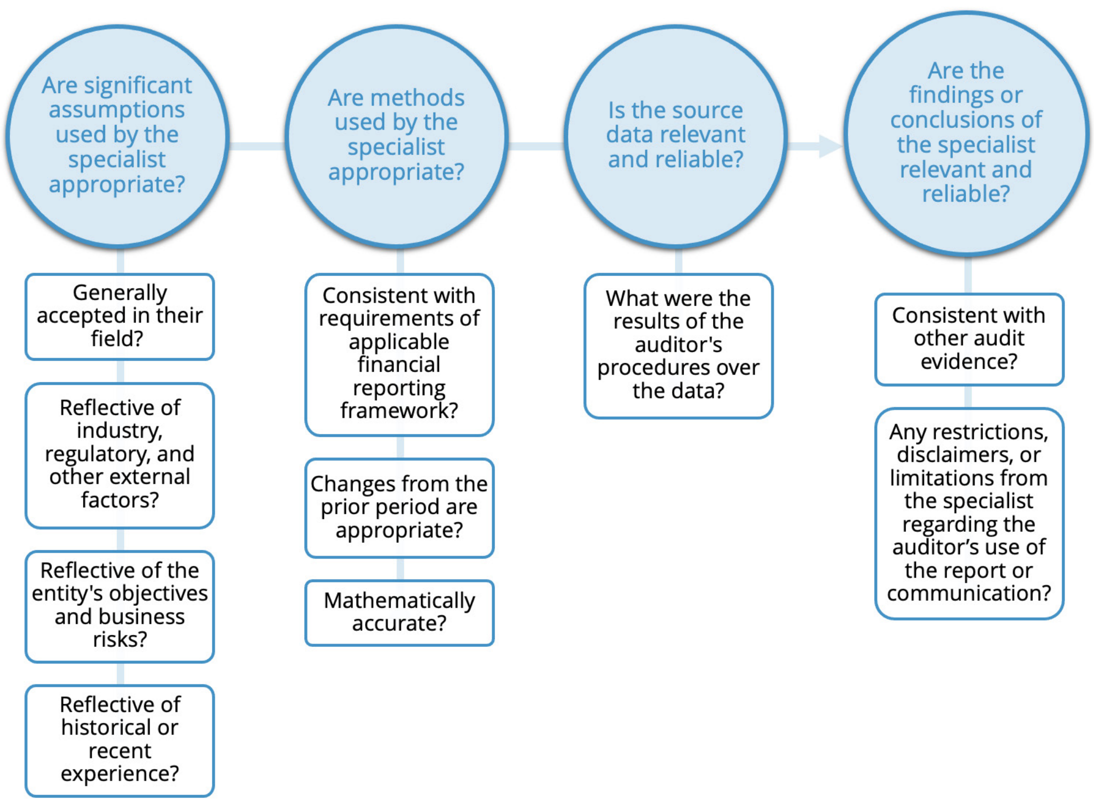
Specialists

SAS 144 (Specialists & Pricing Information) enhances the guidance for (1) the auditor's evaluation of management's use of an external specialist to develop an accounting estimate and (2) the use of an auditor's specialist.

As it relates to the use of a management specialist to develop an accounting estimate, the standard adds applicable material from PCAOB Auditing Standards (AS) 1105, Audit Evidence, intended to enhance audit quality for private companies. Consistent with the extant standards, when a management specialist has prepared information that is used as audit evidence, the auditor needs to evaluate their competency and objectivity and obtain an understanding of their work and its appropriateness.

The additional application material in the diagram below provides further guidance on relevant considerations for this evaluation.

The level of audit evidence needed to satisfy the requirements increases with the increase in significance to the financial statements of the specialist's work, the associated ROMM, and the ability of management to affect the specialist's judgments and with the decrease in the competence, capability, and objectivity of the specialist. When complex or proprietary modeling is used, additional evidence will also be required.



When a management specialist is used by management in preparing the financial statements, the auditor must also determine the need for the use of an auditor's specialist. This is affected by factors including:

- The nature, scope, and objectives of the work of management's specialist,
- Whether management's specialist is employed by the entity or is a party engaged by it to provide relevant services,
- The extent to which management can exercise control or influence over management's specialist (including, when applicable, the organization that employs the individual specialist), thereby influencing the work of management's specialist,
- The competence and capabilities of management's specialist,
- Whether management's specialist is subject to technical performance standards or other professional or industry requirements,
- Any controls within the entity over the work of management's specialist, and
- The auditor's ability to evaluate the work and findings of management's specialist without the assistance of an auditor's specialist.

When an auditor's specialist is used, the auditor must similarly evaluate their competence, capability, and objectivity, the appropriateness of assumptions and methods used, and adequacy of their work for its desired purpose.

Fair Value Pricing Information

SAS 144 also enhances guidance on the use of pricing information from external information sources related to fair value estimates. It adds a new appendix to AU-C 540, Auditing Accounting Estimates and Related Disclosures, taking into account previously released PCAOB guidance. The guidance defines a **pricing service** as:

> An organization that routinely provides uniform pricing information to users, generally on a subscription basis.

When a pricing service is engaged to individually develop a price for a specific financial instrument not routinely priced for its subscribers, the requirements relating to management's and/or the auditor's specialist apply.

What to Expect

The changes from SAS 144 impact primarily the auditor's procedures rather than the deliverables that will be issued as a result of the audit. While the changes are not outward facing, management should expect more detailed inquiries of management and its specialists from the auditors. Management should ensure they have procedures in place to evaluate the competency of its specialists and the quality of source data provided to them.

Furthermore, entities with more complex investment portfolios (i.e. entities for which all investments are not Level 1 in the fair value hierarchy) can expect increased procedures to comply with the guidance surrounding the use of pricing services. In such cases, the auditor may need to rely on an auditor specialist to provide independent fair value estimates. Management should also ensure that they have an understanding of their pricing sources and whether they are pricing services and specialists. This should include an understanding of the pricing sources used by an investment manager or custodian.

SAS 145: Risk Assessment

What's Changing?

SAS 145 (Risk Assessment) supersedes AU-C 315 Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement. The standard focuses on enhanced risk assessments as a driver of audit quality and defines the auditor's responsibilities for understanding the entity's system of internal control, including general information technology (IT) controls, and determining risks of material misstatement, including significant risks.

As part of the revised risk assessment process, the standard introduces new key terms and revises the definition of a **significant risk** as follows:

An identified risk of material misstatement

for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur

or

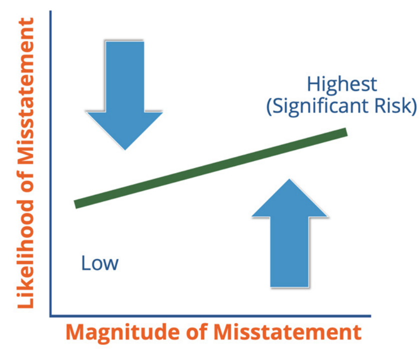
that is to be treated as a significant risk in accordance with the requirements of other AU-C sections[3]:

- Management override of controls
- Revenue recognition
- Related party transactions that are also significant unusual transactions.

As previously defined, the definition of a significant risk focused the auditor on the response to an identified risk (a risk that requires special audit consideration). The revised definition focuses the auditor on the inherent risk assessment, with new terms inherent risk factors and spectrum of inherent risk.

Inherent risk factors are characteristics of an account or disclosure assertion that affect its susceptibility to misstatement, before the consideration of controls. Such factors include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias.

Based on these factors, inherent risk is evaluated on the spectrum of inherent risk, considering both the likelihood and magnitude of a misstatement, as illustrated below:



The guidance in SAS 145 is intended to be scalable based on the complexity of the entity and to modernize the standard for changes in the evolving business environment. The standard also incorporates a significant amount of explanatory guidance in the form of appendices that the auditor may use to understand the entity's system of internal control, including the entity's use of IT. With regard to IT in particular, the guidance clearly defines relevant terms and is more detailed than IT guidance from other standard setters.

3. AU-C 240, *Consideration of Fraud in a Financial Statement Audit* and AU-C 550, *Related Parties*

What To Expect

As part of planning procedures, the auditor:

- Performs risk assessment procedures,
- Obtains an understanding of the entity and its environment and its system of internal control, and
- Identifies and assesses the risk of material misstatement.

These concepts have not fundamentally changed under SAS 145. However, within these concepts, several principles have changed and management should expect an increased emphasis on the risk assessment phase of the audit and the performance of audit procedures that are responsive to the risks identified, including an understanding of controls in place that address such risks. Under SAS 145, the auditor must identify and assess:

- Controls that address significant risks,
- Controls over journal entries,
- Controls for which the auditor plans to test the operating effectiveness, and
- Other controls based on the auditor's judgment.

Based on these controls, the auditor should identify the related IT applications and risks and the general IT controls that address such risks. The auditor must then evaluate the design and evidence the implementation of the identified controls.

Management remains responsible for the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management can best prepare for the upcoming standard by reviewing key controls in place related to significant accounts in preparation for the annual audit.

Conclusion

SAS 143-145 will have a significant impact on upcoming audits beginning with those with 2023 calendar year ends. While the changes primarily affect the auditor's procedures versus the auditor's report, the changes serve to increase audit quality and ensure the auditing standards are modernized with changes in the economic and accounting standard-setting environment. Your Johnson Lambert team is available for further discussion of and preparation for the upcoming standards to ensure you and your organization are prepared.

Are You and Your Organization Ready?	
☐	Understand the underlying data, methodology, and assumptions used in making significant accounting estimates, including when those are developed by a specialist
☐	Understand the source of pricing information for fair value estimates and whether the pricing service is a specialist
☐	Understand controls in place at your organization over the work of management's specialist(s)
☐	Communicate with management's specialist(s) regarding new requirements and the need for enhanced collaboration with the auditor
☐	Review and document key internal controls in place over significant accounts, journal entries, and related IT applications

Author: Melanie Barthel